

106TH CONGRESS  
1ST SESSION

# S. 1732

To amend the Internal Revenue Code of 1986 to prohibit certain allocations of S corporation stock held by an employee stock ownership plan.

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## IN THE SENATE OF THE UNITED STATES

OCTOBER 14, 1999

Mr. BREAU (for himself, Mr. JEFFORDS, Mr. GRASSLEY, Mr. KERREY, and Mr. HATCH) introduced the following bill; which was read twice and referred to the Committee on Finance

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## A BILL

To amend the Internal Revenue Code of 1986 to prohibit certain allocations of S corporation stock held by an employee stock ownership plan.

1 *Be it enacted by the Senate and House of Representa-*  
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. PROHIBITED ALLOCATIONS OF S CORPORA-**  
4 **TIONS STOCK HELD BY AN ESOP.**

5 (a) IN GENERAL.—Section 409 of the Internal Rev-  
6 enue Code of 1986 (relating to qualifications for tax credit  
7 employee stock ownership plans) is amended by redesignig-  
8 nating subsection (p) as subsection (q) and by inserting  
9 after subsection (o) the following new subsection:

1 “(p) PROHIBITED ALLOCATIONS OF SECURITIES IN  
2 AN S CORPORATION.—

3 “(1) IN GENERAL.—An employee stock owner-  
4 ship plan holding employer securities consisting of  
5 stock in an S corporation shall provide that no por-  
6 tion of the assets of the plan attributable to (or allo-  
7 cable in lieu of) such employer securities may, dur-  
8 ing a nonallocation year, accrue (or be allocated di-  
9 rectly or indirectly under any plan of the employer  
10 meeting the requirements of section 401(a)) for the  
11 benefit of any disqualified person.

12 “(2) FAILURE TO MEET REQUIREMENTS.—

13 “(A) IN GENERAL.—If a plan fails to meet  
14 the requirements of paragraph (1), the plan  
15 shall be treated as having distributed to any  
16 disqualified person the amount allocated to the  
17 account of such person in violation of para-  
18 graph (1) at the time of such allocation.

19 “(B) CROSS REFERENCE.—

**“For excise tax relating to violations of paragraph  
(1) and ownership of synthetic equity, see section  
4979A.**

20 “(3) NONALLOCATION YEAR.—For purposes of  
21 this subsection—

22 “(A) IN GENERAL.—The term ‘nonalloca-  
23 tion year’ means any plan year of an employee

1 stock ownership plan if, at any time during  
2 such plan year—

3 “(i) such plan holds employer securi-  
4 ties consisting of stock in an S corpora-  
5 tion, and

6 “(ii) disqualified persons own at least  
7 50 percent of the number of shares of  
8 stock in the S corporation.

9 “(B) ATTRIBUTION RULES.—For purposes  
10 of subparagraph (A)—

11 “(i) IN GENERAL.—The rules of sec-  
12 tion 318(a) shall apply for purposes of de-  
13 termining ownership, except that—

14 “(I) in applying paragraph (1)  
15 thereof, the members of an individ-  
16 ual’s family shall include members of  
17 the family described in paragraph  
18 (4)(D), and

19 “(II) paragraph (4) thereof shall  
20 not apply.

21 “(ii) DEEMED-OWNED SHARES.—Not-  
22 withstanding the employee trust exception  
23 in section 318(a)(2)(B)(i), for purposes of  
24 determining whether an individual is a dis-

1           qualified person, such individual shall be  
2           treated as owning deemed-owned shares.

3           “(4) DISQUALIFIED PERSON.—For purposes of  
4           this subsection—

5           “(A) IN GENERAL.—The term ‘disqualified  
6           person’ means any person if—

7                   “(i) the aggregate number of deemed-  
8                   owned shares of such person and the mem-  
9                   bers of such person’s family is at least 20  
10                  percent of the number of deemed-owned  
11                  shares of stock in the S corporation, or

12                  “(ii) in the case of a person not de-  
13                  scribed in clause (i), the number of  
14                  deemed-owned shares of such person is at  
15                  least 10 percent of the number of deemed-  
16                  owned shares of stock in such corporation.

17           “(B) TREATMENT OF FAMILY MEMBERS.—  
18           In the case of a disqualified person described in  
19           subparagraph (A)(i), any member of such per-  
20           son’s family with deemed-owned shares shall be  
21           treated as a disqualified person if not otherwise  
22           treated as a disqualified person under subpara-  
23           graph (A).

24           “(C) DEEMED-OWNED SHARES.—For pur-  
25           poses of this paragraph—

1                   “(i)     IN     GENERAL.—The     term  
2                   ‘deemed-owned shares’ means, with respect  
3                   to any person—

4                   “(I) the stock in the S corpora-  
5                   tion constituting employer securities  
6                   of an employee stock ownership plan  
7                   which is allocated to such person  
8                   under the plan, and

9                   “(II) such person’s share of the  
10                  stock in such corporation which is  
11                  held by such plan but which is not al-  
12                  located under the plan to participants.

13                  “(ii)     PERSON’S     SHARE     OF  
14                  UNALLOCATED STOCK.—For purposes of  
15                  clause (i)(II), a person’s share of  
16                  unallocated S corporation stock held by  
17                  such plan is the amount of the unallocated  
18                  stock which would be allocated to such per-  
19                  son if the unallocated stock were allocated  
20                  to all participants in the same proportions  
21                  as the most recent stock allocation under  
22                  the plan.

23                  “(D) MEMBER OF FAMILY.—For purposes  
24                  of this paragraph, the term ‘member of the  
25                  family’ means, with respect to any individual—

- 1 “(i) the spouse of the individual,  
 2 “(ii) an ancestor or lineal descendant  
 3 of the individual or the individual’s spouse,  
 4 “(iii) a brother or sister of the indi-  
 5 vidual or the individual’s spouse and any  
 6 lineal descendant of the brother or sister,  
 7 and  
 8 “(iv) the spouse of any individual de-  
 9 scribed in clause (ii) or (iii).

10 A spouse of an individual who is legally sepa-  
 11 rated from such individual under a decree of di-  
 12 vorce or separate maintenance shall not be  
 13 treated as such individual’s spouse for purposes  
 14 of this subparagraph.

15 “(5) TREATMENT OF SYNTHETIC EQUITY.—For  
 16 purposes of paragraphs (3) and (4), in the case of  
 17 a person who owns synthetic equity in the S corpora-  
 18 tion, except to the extent provided in regulations, the  
 19 shares of stock in such corporation on which such  
 20 synthetic equity is based shall be treated as out-  
 21 standing stock in such corporation and deemed-  
 22 owned shares of such person if such treatment of  
 23 synthetic equity of 1 or more such persons results  
 24 in—

1           “(A) the treatment of any person as a dis-  
2           qualified person, or

3           “(B) the treatment of any year as a non-  
4           allocation year.

5           For purposes of this paragraph, synthetic equity  
6           shall be treated as owned by a person in the same  
7           manner as stock is treated as owned by a person  
8           under the rules of paragraphs (2) and (3) of section  
9           318(a).

10          “(6) DEFINITIONS.—For purposes of this  
11          subsection—

12               “(A) EMPLOYEE STOCK OWNERSHIP  
13               PLAN.—The term ‘employee stock ownership  
14               plan’ has the meaning given such term by sec-  
15               tion 4975(e)(7).

16               “(B) EMPLOYER SECURITIES.—The term  
17               ‘employer security’ has the meaning given such  
18               term by section 409(l).

19               “(C) SYNTHETIC EQUITY.—The term ‘syn-  
20               thetic equity’ means any stock option, warrant,  
21               restricted stock, deferred issuance stock right,  
22               or similar interest or right that gives the holder  
23               the right to acquire or receive stock of the S  
24               corporation in the future. Except to the extent  
25               provided in regulations, synthetic equity also in-

1           cludes a stock appreciation right, phantom  
 2           stock unit, or similar right to a future cash  
 3           payment based on the value of such stock or  
 4           appreciation in such value.

5           “(7) REGULATIONS.—The Secretary shall pre-  
 6           scribe such regulations as may be necessary to carry  
 7           out the purposes of this subsection.”

8           (b) COORDINATION WITH SECTION 4975(e)(7).—The  
 9           last sentence of section 4975(e)(7) of such Code (defining  
 10          employee stock ownership plan) is amended by inserting  
 11          “, section 409(p),” after “409(n)”.

12          (c) EXCISE TAX.—

13               (1) APPLICATION OF TAX.—Subsection (a) of  
 14               section 4979A of such Code (relating to tax on cer-  
 15               tain prohibited allocations of employer securities) is  
 16               amended—

17                       (A) by striking “or” at the end of para-  
 18                       graph (1),

19                       (B) by striking the period at the end of  
 20                       paragraph (2) and inserting a comma, and

21                       (C) by striking all that follows paragraph  
 22                       (2) and inserting the following:

23                       “(3) there is any allocation of employer securi-  
 24                       ties which violates the provisions of section 409(p),  
 25                       or

1           “(4) any synthetic equity is owned by a dis-  
 2           qualified person in any nonallocation year,  
 3 there is hereby imposed a tax on such allocation or owner-  
 4 ship equal to 50 percent of the amount involved.”

5           (2) LIABILITY.—Section 4979A(c) of such Code  
 6           (defining liability for tax) is amended to read as fol-  
 7           lows:

8           “(c) LIABILITY FOR TAX.—The tax imposed by this  
 9 section shall be paid—

10           “(1) in the case of an allocation referred to in  
 11 paragraph (1) or (2) of subsection (a), by—

12                   “(A) the employer sponsoring such plan, or

13                   “(B) the eligible worker-owned cooperative,  
 14 which made the written statement described in sec-  
 15 tion 664(g)(1)(E) or in section 1042(b)(3)(B) (as  
 16 the case may be), and

17           “(2) in the case of an allocation or ownership  
 18 referred to in paragraph (3) or (4) of subsection (a),  
 19 by the S corporation the stock in which was so allo-  
 20 cated or owned.”

21           (3) DEFINITIONS.—Section 4979A(e) of such  
 22 Code (relating to definitions) is amended to read as  
 23 follows:

24           “(e) DEFINITIONS AND SPECIAL RULES.—For pur-  
 25 poses of this section—

1           “(1) DEFINITIONS.—Except as provided in  
2 paragraph (2), terms used in this section have the  
3 same respective meanings as when used in sections  
4 409 and 4978.

5           “(2) SPECIAL RULES RELATING TO TAX IM-  
6 POSED BY REASON OF PARAGRAPH (3) OR (4) OF  
7 SUBSECTION (a).—

8           “(A) PROHIBITED ALLOCATIONS.—The  
9 amount involved with respect to any tax im-  
10 posed by reason of subsection (a)(3) is the  
11 amount allocated to the account of any person  
12 in violation of section 408(p)(1).

13           “(B) SYNTHETIC EQUITY.—The amount  
14 involved with respect to any tax imposed by rea-  
15 son of subsection (a)(4) is the value of the  
16 shares on which the synthetic equity is based.

17           “(C) SPECIAL RULE FOR PROHIBITED AL-  
18 LOCATION DURING FIRST NONALLOCATION  
19 YEAR.—For purposes of subparagraph (A), the  
20 amount involved for the first nonallocation year  
21 of any employee stock ownership plan shall be  
22 determined by taking into account the total  
23 value of all the deemed-owned shares of all dis-  
24 qualified persons with respect to such plan.

1           “(D) STATUTE OF LIMITATIONS.—The  
 2           statutory period for the assessment of any tax  
 3           imposed by this section by reason of paragraph  
 4           (3) or (4) of subsection (a) shall not expire be-  
 5           fore the date which is 3 years from the later  
 6           of—

7                   “(i) the allocation or ownership re-  
 8                   ferred to in such paragraph giving rise to  
 9                   such tax, or

10                   “(ii) the date on which the Secretary  
 11                   is notified of such allocation or owner-  
 12                   ship.”

13       (d) EFFECTIVE DATES.—

14           (1) IN GENERAL.—The amendments made by  
 15           this section shall apply to plan years beginning after  
 16           December 31, 2000.

17           (2) EXCEPTION FOR CERTAIN PLANS.—In the  
 18           case of any—

19                   (A) employee stock ownership plan estab-  
 20                   lished after July 14, 1999, or

21                   (B) employee stock ownership plan estab-  
 22                   lished on or before such date if employer securi-  
 23                   ties held by the plan consist of stock in a cor-  
 24                   poration with respect to which an election under

1           section 1362(a) of the Internal Revenue Code  
2           of 1986 is not in effect on such date,  
3           the amendments made by this section shall apply to  
4           plan years ending after July 14, 1999.

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